

# **F-Squared Investments, Inc.**

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## **Form ADV Part 2A Brochure**

January 2014

This brochure provides information about the qualifications and business practices of F-Squared Investments Inc. (hereinafter “F-Squared”). If you have any questions about the contents of this brochure, please contact us at 866-288-7657 or [info@f2inv.com](mailto:info@f2inv.com). The information in this brochure has not been approved or verified by the United States Securities and Exchange Commission (the “SEC”) or by any state securities authority.

Registration with the SEC does not imply that F-Squared or any person associated with F-Squared has achieved a certain level of skill or training.

Additional information about F-Squared is available at [www.adviserinfo.sec.gov](http://www.adviserinfo.sec.gov).

## **Item 2: Summary of Material Changes**

F-Squared has revised its brochure to clarify its two primary business lines:

- (i) F-Squared provides index products to third party entities; and
- (ii) F-Squared provides advisory services through the implementation of its index products.

In addition, F-Squared has also removed references to information prior to 2008.

F-Squared's last annual Form ADV update was filed on March 28, 2013.

## Item 3: Table of Contents

<b>Item 1</b> Cover Page.....	Page 1
<b>Item 2</b> Material Changes.....	Page 2
<b>Item 3</b> Table of Contents.....	Page 3
<b>Item 4</b> Advisory Business.....	Page 4
<b>Item 5</b> Fees and Compensation.....	Page 5
<b>Item 6</b> Performance-Based Fees.....	Page 6
<b>Item 7</b> Types of Clients.....	Page 6
<b>Item 8</b> Methods of Analysis, Investment Strategies and Risk of Loss.....	Page 7
<b>Item 9</b> Disciplinary Information.....	Page 10
<b>Item 10</b> Other Financial Industry Activities and Affiliations.....	Page 10
<b>Item 11</b> Code of Ethics, Participation or Interest in Client Transactions and Personal Trading.....	Page 10
<b>Item 12</b> Brokerage Practices.....	Page 12
<b>Item 13</b> Review of Accounts.....	Page 12
<b>Item 14</b> Client Referrals and Other Compensation.....	Page 12
<b>Item 15</b> Custody.....	Page 13
<b>Item 16</b> Investment Discretion.....	Page 13
<b>Item 17</b> Voting Client Securities.....	Page 13
<b>Item 18</b> Financial Information.....	Page 14

## Item 4: Advisory Business

### ***Description of our Firm***

F-Squared Investments Inc. (f/k/a F-Squared Investments, LLC, hereinafter “F-Squared”) is an SEC registered investment management firm located in Wellesley, Massachusetts that commenced operations as an investment adviser in 2008.<sup>1</sup>

F-Squared is a wholly-owned subsidiary of F-Squared Investment Management, LLC. F-Squared Investment Management, LLC is a privately owned company with no one individual member owning 25% or more of the company as of November 30, 2013. Howard Present is the President and Chief Executive Officer of F-Squared.

### ***Types of Services We Offer***

F-Squared provides various index products (the “Index Provider Services”) and, separately, provides investment advisory services relating to those index products (the “Advisory Services”).

#### *Index Provider Services*

##### *AlphaSector Indexes*

F-Squared has created a suite of indexes (the “AlphaSector Indexes”) designed to meet real investment needs. The AlphaSector Indexes seek to achieve relative returns in rising markets and limit negative returns in declining markets. The AlphaSector Indexes are quantitative models programmed to utilize price movements and volatility of exchange traded funds (“ETFs”) as a criteria for component inclusion. There are 75 AlphaSector Indexes (including both standard and customized indexes). F-Squared licenses the right to use the AlphaSector Indexes to unaffiliated third parties.

##### *Portfolio Replication Services*

Using its proprietary PoRT technology, F-Squared creates model investment portfolios for licensing. PoRT permits the construction of model portfolios that seek to replicate those of certain equity-based mutual funds, closed-end funds or variable trust funds in the United States. PoRT replication services are generally delivered as model portfolios for execution by the unaffiliated third party client’s platform or to the trading and custodial provider of the unaffiliated third party client’s choice.

#### *Advisory Services*

F-Squared provides investment advisory services on a discretionary basis to separately managed accounts (the “SMAs”).

F-Squared’s Advisory Services utilize investment portfolios designed to create long-term value by tracking or replicating one or a combination of the AlphaSector or AlphaCycle Indexes (such portfolios, the “Strategies”). The Strategies are offered to unaffiliated investment advisers, broker-dealers, wealth managers, family offices, trust companies and institutional investors.

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<sup>1</sup> F-Squared Investments, LLC commenced operations as an investment adviser in 2006.

## ***Tailored Advisory Services***

F-Squared provides the Advisory Services by seeking to replicate in an account one or more of the AlphaSector and AlphaCycle Indexes. Although F-Squared generally does not tailor its Advisory Services, F-Squared may offer custom advisory services to institutional investors upon request. F-Squared generally does not allow clients to impose restrictions on investing in certain securities or types of securities.

## ***Wrap Fee Programs***

F-Squared does not currently participate in any wrap fee programs.

## ***Assets under Management***

As of November 30, 2013, the total assets under management<sup>2</sup> for F-Squared are as follows:

<b><i>Discretionary:</i></b>	\$ 60,256,255
<b><i>Non-Discretionary</i></b>	0
<b><i>Total:</i></b>	\$ 60,256,255

## **Item 5: Fees and Compensation**

### ***Fee Schedule***

#### *Index Provider Services*

In connection with the licensing of its AlphaSector and AlphaCycle Indexes, F-Squared is entitled to receive a fee based on the market value of assets managed by the third party using the AlphaSector or AlphaCycle Indexes. F-Squared generally receives this fee on a monthly or quarterly basis, typically paid in arrears. The rates for such fee generally range from 10 to 60 basis points. Such fees are generally not negotiable. Third party unaffiliated entities that license the use of the AlphaSector or AlphaCycle Indexes may charge fees and expenses with which F-Squared has no involvement. Such entities may employ fee and expense structures, as well as timing, that differ from F-Squared's.

<u>ASSET LEVEL</u>	<u>ALPHASECTOR STRATEGIES (MONTHLY)</u>
Firm asset levels up to \$25 million:	40bp (0.40%)
Firm asset levels > \$25 million and < \$100 million:	35bp (0.35%)
Firm asset levels > \$100 million:	30bp (0.30%)

<u>ASSET LEVEL</u>	<u>ALPHASECTOR PREMIUM STRATEGIES (WEEKLY)</u>
Firm asset levels up to \$100 million:	60bp (0.60%)
Firm asset levels > \$100 million:	55bp (0.55%)

<u>ASSET LEVEL</u>	<u>ALPHACYCLE STRATEGIES</u>
Asset levels up to \$100 million:	35bp (0.35%)
Asset levels > \$100 million and < \$500 million:	25bp (0.25%)
Asset levels > \$500 million:	20bp (0.20%)

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<sup>2</sup> In addition, as of November 30, 2013, unaffiliated third parties had \$3,303,851,599 in fee-paying assets under management pursuant to F-Squared's Index Provider Services.

Typical fees charged by F-Squared for PoRT replication services are as follows:

<u>ASSET LEVEL</u>	<u>CUSTOM REPLICATION</u>
Asset levels up to \$100 million:	25bp (0.25%)
Asset levels > \$100 million and < \$250 million	22.5bp (0.225%)
Asset levels > \$250 million and < \$1 billion	20bp (0.20%)

The fees charged by F-Squared for the BetaHedge™ overlay strategy are typically 10bp (0.10%).

#### *Advisory Services*

F-Squared receives management fees for the provision of its Advisory Services.

With respect to the SMAs, F-Squared receives a management fee based on the market value of the total assets invested by the client using the AlphaSector or AlphaCycle Indexes. F-Squared will receive the management fee on a monthly or quarterly basis, paid in arrears. The rates for such management fee range from 10 to 60 basis points. Such fees are generally not negotiable.

#### ***Payment of Fees***

Both Index Provider Service counterparties and Advisory Service clients are generally billed at the end of each month or quarter, as applicable. Index Provider Service counterparties and Advisory Service clients that operate on platforms may use different billing methods for applying fees to their underlying investors.

#### ***Other Types of Fees or Expenses***

In addition to the management fees described above, Index Provider Service and Advisory Service clients may also incur fees and expenses charged by custodians and imposed by financial intermediaries, including but not limited to any transaction charges imposed by a broker dealer with which an independent investment manager effects transactions for the Client's account(s). See Item 12 which describes F-Squared's brokerage practices and the process for reviewing and recommending a broker dealer for Advisory Service clients' transactions in applicable situations.

## **Item 6: Performance-Based Fees**

F-Squared does not charge performance-based fees, other than with respect to clients utilizing the AlphaSector Hedged Portfolio Index Strategy. The typical performance-based fee is 20% of the quarterly return of the AlphaSector Hedge Portfolio Index above 2%.

## **Item 7: Types of Clients**

#### ***Index Provider Services***

F-Squared provides Index Provider Services to third party unaffiliated entities, including investment advisers. F-Squared does not currently have any requirements for entering into an index provider relationship.

## ***Advisory Services***

F-Squared provides Advisory Services to a number of clients which may include pensions, trusts, other business entities and individuals.

There are minimums for accounts, varying by account type. F-Squared may waive any and all minimum account requirements at their sole discretion.

## **Item 8: Method of Analysis, Investment Strategies and Risk of Loss**

### ***Index Provider Services – Description of Index or Portfolio Replication Construction***

The investment rationale of the AlphaSector Indexes is based on seeking to avoid market declines. The index algorithms generally seek to control risk in down markets and participate in up markets. Index components include up to 9 ETFs reflecting the primary sectors of the U.S. economy. In periods of extreme distress, the AlphaSector Indexes may allow partial or complete allocations to cash equivalents. There are currently 75 standard and/or customized AlphaSector Indexes.

The investment rationale of the AlphaCycle Indexes is based on F-Squared's PoRT technology engine. PoRT seeks to permit the replication of portfolios of select equity-based mutual funds, closed-end funds or variable trust funds in the United States.

### ***Methods of Analysis for Advisory Services***

The AlphaSector Strategies seek to track or replicate one or more of the AlphaSector Indexes in an effort to modestly outperform its assigned benchmark in growth markets and significantly outperform its benchmark during bear markets. The quantitative models underlying the AlphaSector Strategies are based on three primary components:

- Historical Price Return
- Volatility
- Changing Levels of Volatility

The AlphaSector Strategies cover several major asset classes: U.S. Equity, International, Fixed Income, and Real Assets (Gold and Real Estate), plus asset allocation strategies that combine various combinations of these core asset classes.

The AlphaCycle Strategies are driven by F-Squared's proprietary technology engine, PoRT™. PoRT seeks to permit the user to replicate the portfolios of select equity-based mutual funds, closed end funds, or variable trust funds in the United States.

### ***Investment Strategies for Advisory Services***

F-Squared primarily offers two suites of products: AlphaSector Strategies and AlphaCycle. Only the AlphaSector Strategies are available via Advisory Services.

## Advisory Services - Portfolio Construction and Design

All AlphaSector Rotation Strategy portfolios are reviewed monthly and all AlphaSector Premium Strategy portfolios are reviewed weekly for reconstitution and rebalancing.

The following is a summary of the core AlphaSector Strategies. The AlphaSector U.S. Equity Strategies (AlphaSector Rotation Strategy and AlphaSector Premium Strategy) seek to replicate the applicable index ETFs representing the 9 sectors of the U.S. economy or short-term Treasuries. The implementation of the strategy is most often through ETFs, which are low cost, highly liquid index-linked vehicles tracking the performance of each respective sector. The ETFs most often used are published by industry leading ETF providers representing the 9 sectors of the U.S. economy, and an ETF tracking short term Treasury securities as the proxy for a cash equivalent. As such, there are a maximum number of 9 securities in the portfolio at any one time, resulting in operational ease and lower transaction costs.

The AlphaSector Global Strategy is a blend of two index strategies, the AlphaSector U.S. Equity Strategy and the AlphaSector International Strategy. The AlphaSector International Strategy includes 5 ETFs reflecting the key world economic regions outside the U.S. as well as a Short-term Treasury ETF used as a proxy for a cash equivalent. Alpha Sector INfInity Strategy is a diversified multi-sector, inflation neutral fixed income offering which includes ETFs tracking 6 bond sectors and 1 short-term treasury ETF as a cash equivalent.

AlphaSector Allocator Strategy is a diversified portfolio of the U.S. Equity, International and Fixed Income Strategies adding in ETFs tracking “alternative” asset classes such as gold and REITs.

AlphaSector Hedge Portfolio Strategy represents an investment “overlay” applied to the live investment signals of the AlphaSector U.S. Equity Index. The overlay represents the application of leverage and short exposure and is generated through the use of a rules-based, quantitative model.

Default “position” within each AlphaSector Index is typically to have all available ETFs (other than cash equivalents) invested and equally weighted within that index or sleeve at the time of rebalancing. Decisions to remove a sector or asset class from the portfolio at any time are based on a probabilistic determination that that sector or asset class is viewed as likely to lose money on a forward looking basis.

The AlphaCycle Strategies are select portfolios of actively managed mutual funds that have been selected by third-party institutional clients. The AlphaCycle Strategies attempt to capture excess return for the period of time during which [they] outperform the market. There are currently 15 discrete AlphaCycle Strategies covering defined domestic equity asset classes. All AlphaCycle Strategies are designed to outperform their benchmarks and peer groups with modestly reduced risk.

The AlphaCycle Strategies are generally structured as part of a two-step process:

1. Construction of custom portfolios of actively managed mutual funds. This can be done to achieve consistent outperformance (alpha generation) or to reflect an existing investment portfolio where conversion to individual securities offers investment or financial benefits.
2. Creation of tracking portfolios of individual stocks.

For the sake of clarity, F-Squared’s AlphaCycle investment solutions do not include the direct investment into any mutual fund. All investments are into portfolios of individual stocks that are generated by PoRT.

The only inputs into PoRT are publicly available information, which includes the daily performance result of the target portfolio and the underlying funds, historical fund holdings as periodically reported to the SEC, and other data deemed useful by F-Squared. PoRT then uses a dynamic regression engine on top of a massive scale optimizer to generate the relevant portfolio.



## ***Risk of Loss***

All investments in securities include a risk of loss that clients should be prepared to bear.

The principal risks of the Strategies are as follows:

- **Market Risk:** The risk that the value of the securities in which the Strategies invest may drop in reaction to tangible and intangible events and conditions, independent of a security's particular underlying circumstances. For example, political, economic, and social conditions may cause a change in the value of the securities. Price changes may be temporary or may last for extended periods.
- **Equity Securities Risk:** The risk that events or circumstances at a particular industry, or a particular company within an industry will impact the value of the stocks and ETFs held by the Strategy and thus, the value of your investment over short or extended periods.
- **Interest-Rate Risk:** The risk that fluctuations in interest rates may cause investment prices to fluctuate and impact the value of Fixed Income securities or ETFs held by the Strategy. For example, when interest rates rise, yields on existing bonds become less attractive causing their market values to decline.
- **ETF Risk:** The risk that the value of an ETF in which a Strategy invests will be more volatile than the underlying portfolio of securities the ETF is designed to track, or that the costs to the fund of owning shares of the ETF will exceed those the fund would incur by investing in such securities directly.
- **Sector Concentration Risk:** The risk that events negatively affecting an industry or market sector in which the Strategy invests will cause the overall value of the Strategy to decline. To the extent that some of the Strategies invest significant portions of their portfolio in ETFs representing particular markets or sectors (such as Energy, Healthcare, Real Estate, etc.) or in an ETF representing U.S. Treasuries, the Strategy is more vulnerable to conditions that negatively affect such sectors as compared to an investment strategy that is not significantly invested in such sectors.
- **Turnover Risk:** The risk that frequent trading will result in increased brokerage and other transaction-related costs, as well as less favorable tax treatment of short-term capital gains that can negatively impact an investor's overall investment as compared to investments in strategies with low turnover.
- **U.S. Government Securities Risk:** The risk that U.S. Government securities in a Strategy will be subject to price fluctuations, or that an agency or instrumentality will default on an obligation not backed by the full faith and credit of the United States.
- **Quantitative Risk:** The risk that the effectiveness of the quantitative model used for the strategy can dissipate over time as similar Strategies are adopted and as the market becomes more efficiently priced.
- **Programming / Modeling Risk:** F-Squared's research and modeling process is extremely complex and the results of that process must then be translated into computer code. Although F-Squared seeks to hire individuals skilled in each of these functions and to provide appropriate levels of oversight, the complexity of the individual tasks, the difficulty of integrating such tasks, and the limited ability to perform "real world" testing of the end product raises the chances that the finished model may

contain an error; one or more of such errors could adversely affect a client's portfolio and likely would not constitute a trade error under F-Squared's policies.

- **System Risk:** F-Squared relies extensively on computer programs and systems in its proprietary modeling to evaluate securities, to monitor its portfolio, and to generate reports that are critical to oversight of its activities. In addition, certain systems operated by third parties, including counterparties and service providers, may not be in a position to verify the risks or reliability of such third-party systems. These programs or systems may be subject to certain defects, failures or interruptions, including, but not limited to, those caused by computer "worms," viruses and power failures. Any such defect or failure could have a material adverse effect on F-Squared's activities. For example, such failures could cause settlement of trades to fail, lead to inaccurate accounting, recording or processing of trades, and cause inaccurate reports, which may affect F-Squared's ability to monitor its investment portfolios and its risks.
- **Operational Risk:** F-Squared has developed systems and procedures to control operational risk. Operational risks arising from mistakes made in the trading confirmation or settlement of transactions, from transactions not being properly booked, evaluated or accounted for or other similar disruption in F-Squared's operations may cause F-Squared to suffer financial loss; the disruption of its business; liability to clients or third parties; regulatory intervention; or reputational damage. F-Squared relies heavily on its financial, accounting and other data processing systems.

## **Item 9: Disciplinary Information**

This Item is not applicable.

## **Item 10: Other Financial Industry Activities and Affiliations**

### ***Broker-Dealer Affiliations***

F-Squared is not registered nor does it have any pending application to register as a broker-dealer.

### ***Futures/Commodities Affiliations***

Neither F-Squared nor any of its management persons are registered, or have an application pending to register, as a futures commission merchant, commodity pool operator, commodity trading advisor, or an associated person of the foregoing entities.

### ***Investment Adviser Affiliations***

F-Squared is a subsidiary of F-Squared Investment Management, LLC. Other registered investment adviser subsidiaries of F-Squared Investment Management, LLC include F-Squared Institutional Advisors, LLC, F-Squared Retirement Solutions, LLC, F-Squared Alternative Investments, LLC, and F-Squared Capital, LLC. F-Squared does not recommend or select any of the above affiliates, or any other investment adviser, for its clients.

## **Item 11: Code of Ethics, Participation in Client Transactions and Personal Trading**

F-Squared has adopted a Code of Ethics (the "Code") which sets forth high ethical standards of business conduct for our employees and governs a number of potential conflicts of interest that we may encounter

when providing investment advisory services. The Code is based on the principle that F-Squared owes a fiduciary duty to the investors for which we serve as an adviser. In adherence with the Code, F-Squared and its employees must avoid activities, interests and relationships that might interfere or appear to interfere with making decisions in the best interests of our clients. The Code seeks to place the interests of F-Squared clients over the interests of the firm and any of its employees, and to comply with the applicable Federal securities laws and other applicable law.

F-Squared distributes the Code to each employee at the time of hire and annually thereafter. Each employee is required to sign the Code acknowledging that they have read, understand, and will abide by the Code and its requirements. All employees receive training and are monitored for compliance with the Code.

F-Squared will provide a copy of our Code to any client or prospective client upon request.

Our Code includes, but is not limited to the following:

- Requirements on fiduciary duty
- Prohibitions on the acceptance of gifts and entertainment that exceed our policy standards
- Prohibitions on insider trading and communication of material non-public information
- Requirements on the handling of confidential information
- Requirements for pre-clearance of employee transactions
- Identification and pre-clearance requirements on accounts where employees have beneficial interest
- Requirements for reporting applicable personal securities transactions

#### ***Personal Securities Transactions Requirements***

All Access Persons (any employee of F-Squared who has access to nonpublic information concerning any clients' securities transactions or account holdings; has access to securities recommendations delivered to clients; or is a director or executive officer) must not engage, and must not permit any other person or entity to engage, in any purchase or sale of a Covered Security (all securities except Exempt Securities set forth below) in which such Access Person has, or by reason of the transaction will acquire any Beneficial Ownership (direct or indirect pecuniary interest), unless (i) the transaction is an Exempt Security (as set forth below) or (ii) he/she has have complied with the provisions set forth below.

#### ***Pre-clearance***

Access Persons must seek to obtain pre-clearance trading approval from the Chief Compliance Officer to purchase or sell any Covered Security which has been placed on the "Restricted List" or the "Pre-Clearance List" for which the person has or will have by reason of the trade a Beneficial Ownership and that F-Squared actively engages in trading, advisory services or performs research on such Covered Security.

Finally, Access Persons must seek to obtain pre-clearance trading approval from the Chief Compliance Officer before directly or indirectly acquiring beneficial ownership in any security in an initial public offering or in a limited offering.

In addition to Access Persons, all employees of F-Squared are required to receive pre-clearance trading approval from the Chief Compliance Officer to purchase or sell any security placed on the "Pre-Clearance List" or the "Restricted List."

#### ***Exempt Securities***

Access Persons are required to report all transactions in Covered Securities. The following are generally not considered Covered Securities:

- Direct obligations of the Government of the United States;
- Bankers' acceptances, bank certificates of deposit, commercial paper and high quality short-term debt instruments, including repurchase agreements;
- Shares issued by money market funds;
- Shares issued by open-end funds except Reportable Funds (any Fund for which F-Squared serves as investment adviser or any fund whose investment adviser controls, is controlled by, or is under common control with F-Squared).

## **Item 12: Brokerage Practices**

### *Index Provider Services*

Brokerage practices are not applicable with respect to F-Squared's Index Provider Services.

### *Advisory Services*

For SMAs for investors, F-Squared may from time to time recommend a broker-dealer to execute the trading of underlying securities. In those circumstances, F-Squared will use best efforts to select and recommend a broker-dealer that F-Squared believes will provide the best services at the lowest commission rates. When reviewing a brokerage firm and the services they provide, our assessment includes, but is not limited to the following:

- Reputation/Stability of brokerage firm
- Ability to execute trades in a timely and efficient manner
- Ability to interface with client's custodian bank
- Competitive Commission Rates

F-Squared currently has not entered into any formal soft dollar arrangements.

Practices surrounding aggregation of purchase or sale of securities for Advisory Services client accounts are not applicable. Any aggregation of orders would be done by the underlying SMA platform manager.

## **Item 13: Review of Accounts**

F-Squared reviews its Advisory Services accounts as described below.

F-Squared generally does not have access to client accounts for SMA relationships. In limited circumstances, F-Squared will manage a number of accounts for friends and family. These accounts are reviewed quarterly to ensure that all transactions are in accordance with Strategy instructions and that any tracking error to the applicable AlphaSector Index is within a reasonably acceptable threshold. These accounts receive confirmation of activity reports post any trading activity and receive account statements on a quarterly and annual basis. These reports are provided by the custodian or SMA platform manager that administers the account.

## **Item 14: Client Referrals and Other Compensation**

### ***Other Compensation***

F-Squared does not have any compensation agreements where we receive cash or other economic benefit from someone who is not a client of ours in connection with providing services to our clients.

## ***Client Referrals***

### ***Index Provider Services***

F-Squared may compensate third party solicitors for client referrals in connection with counterparties identified for its index provider business.

### ***Advisory Services***

F-Squared does not directly or indirectly compensate any third party solicitor for individual advisory client referrals.

## **Item 15: Custody**

F-Squared currently maintains a small number of “friends and family” accounts through Folio Investments, Inc. an SMA platform manager for which it has access to view balances and execute trades consistent with the AlphaSector Strategies and is deemed to have custody of such account assets. Clients in these accounts may obtain account statements from a qualified custodian and clients should carefully review those statements.

## **Item 16: Investment Discretion**

### ***Index Provider Services***

F-Squared does not have investment discretion or manage client assets in connection with its Index Provider Services.

### ***Advisory Services***

F-Squared provides its Advisory Services on a discretionary basis. F-Squared has the authority to make investment decisions in accordance with the applicable governing documents of the SMA relationship.

F-Squared also maintains limited discretion over a small number of “friends and family” accounts through Folio Investments, Inc. an SMA platform manager. The discretion for these accounts involves limited access to balance inquiries and execution of trades in accordance to the models for which the clients have subscribed.

F-Squared also maintains limited discretion over a small number of institutional accounts. The discretion for these accounts involves limited access to balance inquiries and execution of trades in accordance to the AlphaSector Index for which the clients have subscribed.

To the extent that F-Squared has investment discretion and the mandate to implement or seek to replicate an index on behalf of an Advisory Services client, F-Squared will do so after distribution of any index information. Index Provider Services counterparties and Advisory Services clients that implement the index on their own (such that F-Squared does not have investment discretion) may be disadvantaged in the event of a delay or lag in their implementation of or attempt to replicate an index relative to the dissemination of index information.

## **Item 17: Voting Client Securities**

### ***Index Provider Services***

Proxy voting is not applicable to F-Squared’s Index Provider Services business.

### ***Advisory Services***

Except when a client has retained proxy voting authority, F-Squared will vote proxies relating to securities held in advisory client portfolios in accordance with its proxy voting policies and procedures.

### **Item 18: Financial Information**

This Item is not applicable.